Flexible Mechanisms to Support a New Climate Change Regime: The Clean Development Mechanism and Beyond

Report of a CEPS Task Force

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Executive Summary

The Bali Action Plan envisages the possibility to introduce new flexible mechanisms in support of a future international climate change regime. These include, among others, sectoral crediting, sectoral trading, Nationally Appropriate Mitigation Plans (NAMAs) and Reduction of Emissions from Deforestation and forest Degradation (REDD). Meanwhile, there has been continuous discussion on reform of the Clean Development Mechanism (CDM) and Joint Implementation (JI) – and their several variations. This report considers and compares the relative merits of a selection of these proposed mechanisms on the basis of their compliance with a set of selected objectives. Its findings and recommendations are aimed at international negotiators as well as at EU stakeholders (including business) with a view to contributing to the discussion on existing and new flexible mechanisms.

The basic assumption is that flexible mechanisms will play a crucial role not only in facilitating a positive outcome in the UN climate negotiations, but will also inspire a wide range of actions on their own. Moreover, they are expected to provide a focus on business investment. Like the current climate change regime, subsequent periods will witness the co-existence of multiple mechanisms that can run concurrently or in combination with one another.

This report first outlines the various motives attributed to the different stakeholders behind the flexible mechanisms and takes stock of the experience acquired with the existing mechanisms under the Kyoto Protocol. We then explore four mechanisms (reformed CDM, reformed JI, sectoral crediting and sectoral trading) and compare these options against three sets of objectives: environmental integrity, enhanced investment and institutional strength at the international level (e.g. integrity of mechanisms with the overall architecture, compatibility between mechanisms and coherence of the framework).

This report is written in non-technical language with the aim of addressing a wide range of stakeholders. It focuses on key issues such as 'motivations', 'mechanism options', 'lessons' and 'objectives', while fully recognising the importance of other issues not covered here.

I. Key messages

1. *There are different motivations behind flexible mechanisms.*

Although recognising that there are additional driving forces behind the proposed mechanisms, the Task Force members concluded that the options under consideration have been principally shaped by four major motivations: reducing greenhouse gas (GHG) emissions, developing a

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carbon market, diffusing technology and substantially increasing the magnitude of financing. This array of motivations implies that it may not be sufficient to simply reform existing mechanisms but that they will need to be supplemented with new ones. The availability of new flexible mechanisms will most likely encourage countries to take on more stringent levels of commitments than they could by their own efforts alone, thereby facilitating the conclusion of a global comprehensive agreement. Moreover, flexible mechanisms can be regarded as a catalyst to re-direct financial and investment flows to a range of mitigation opportunities across sectors and activities. While there is a call, particularly from the EU and some stakeholders, to move from pure offsetting to crediting in order to scale up global emissions reductions, ultimately achieving the climate objective will depend on the level of international commitments undertaken as well as on the nature or design of any flexible mechanism finally devised.

For developing countries, it is important that existing and new mechanisms allow growth and development to continue in a robust and environmentally-sound manner, through incremental investment from Annex I countries and businesses. They should also lead to credits that are redeemable in the external market.

2. *Supply and demand need to be balanced.*

The impact of flexible mechanisms on GHG emissions reductions depends on the balance of supply and demand and the price level they are linked to in the carbon market. An increase in the supply of credits needs in some manner to be balanced by an increase in demand.

3. *There are many lessons to be learned from existing mechanisms.*

To date, most of the lessons from existing mechanisms have been learned by taking stock of the Clean Development Mechanism (CDM).

Clean Development Mechanism (CDM). The CDM has achieved a number of important benefits: GHG emissions reductions and sustainable development in non-Annex countries; first steps towards MRV (measurement, reporting and verification) and GHG accounting; participation of the private sector; investment flows to developing countries; raising awareness of abatement opportunities; and revenue generation. Areas for further discussion include the uneven distribution of projects, preferential treatment for Least Developed Countries (LDCs), additionality, administrative and organisational issues, offsetting and technology transfer. Two areas in need of improvement are: Programmes of Activities (PoAs) and sectoral benchmarking in the CDM.

Joint Implementation (JI). JI started more recently and operates on a smaller scale. Simplification of procedures and relative flexibility in scope and process contributed to a considerable increase in the number of JI projects under the Track I. Some areas for discussion and ongoing improvements are similar to those under the CDM: simplification of baseline setting and extension of the scope.

Assigned Amount Unit (AAU) trading/Green Investment Scheme (GIS). The design of AAU trading system has been left to participating Annex I countries. One form of AAU trading is the GIS, a scheme that attempts to finance environmental measures with revenues from the sale of surplus AAUs. The GIS has less history and operates on a smaller scale. Among the most critical issues are double-counting of units, a host country's capacity to run the scheme, enforcement of its pledge to implement environmental measures and transparency in AAU transactions.

4. *New mechanism options exist.*

Like existing mechanisms, all new flexible mechanisms would aim to contribute to advancing climate objectives, i.e. achieving real global emissions reductions and possibly other specific objectives such as sustainable development, technology transfer and financing.

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CDM. Programmes of Activities (PoAs) are a programmatic version of the CDM, registering a set of activities of the same type under a single umbrella. Sectoral benchmarking in the CDM credits emissions reductions below the baseline based on a pre-determined benchmark for a sector or a subsector. Expansion of the scope to sectoral and programmatic activities could help to strengthen the CDM and address more mitigation opportunities. On the other hand, an increase in the number of CDM projects would require improvements in efficiency of administration and an increase in the transparency of governance.

JI. To become an optimally functioning mechanism, JI must deal with administrative and organisational issues pertaining to the Joint Implementation Supervisory Committee (JISC) as well as more technical issues such as baseline setting and methodology choices.

Sectoral crediting. A sectoral crediting mechanism credits emissions reductions from a covered sector against a threshold well below the 'business as usual' scenario. Sectoral crediting could set a price signal for a broader part of the economy, including power and key industry sectors. A technical merit is its circumvention of the additionality test problems on a project basis. There are several challenges: preventing double-counting, setting the boundaries of the sector, establishing the baseline that is substantiated by data collection and incorporates the specific circumstances of a country, sector, or technology; and upgrading technical and institutional capacity. For baseline setting, it is worth mentioning that in some non-Annex I countries many of the industries to be covered are either owned or operated by governments. Several questions remain open to debate: i) Should credits be issued directly to companies in sectors or channelled through the government? ii) Can sectoral crediting based on no-lose targets co-exist with the current CDM or other flexible mechanisms? iii) Will the mechanism be structured to encourage upfront private sector investment?

Sectoral trading. Sectoral trading is a cap-and-trade scheme applied to a whole sector or a sub-sector within a country. The scheme is aimed at countries that are not yet ready to take on binding national targets but are prepared to take on binding targets in key sectors such as power and industry. If the government has taken on a binding target for the sector, the sectoral cap-and-trade scheme would be mandatory in principle. In addition to environmental integrity and involvement of the private sector, the benefit of sectoral trading is the possible creation of a level playing field, which is a decisive factor for energy-intensive industry that is competing globally irrespective of Annex I/non-Annex I country borders. Some challenges are similar to those of sectoral crediting: boundary setting; and specific circumstances of a country, a sector or a technology.

5. ***Mechanisms can be compared according to at least three objectives environmental integrity, enhanced public and private investment and institutional strength at an international level.***

The Task Force has formulated three sets of objectives that any reformed or new mechanism should meet: environmental integrity, enhanced investment and institutional strength at an international level. These three objectives are considered to be common to the four mechanism options – reformed CDM, reformed JI, sectoral crediting and sectoral trading – although their relevance may vary from one option to another. While there are other equally important objectives, such as contributing to sustainable development, competitiveness and a level-playing field, the latter of which is immensely important for energy-intensive industry, they would not necessarily apply to all mechanisms or sectors.

Environmental integrity. Ultimately all mechanisms need to guarantee that they deliver 'real' emissions reductions. One of the ongoing controversies relates to the current CDM as being largely offsetting in nature. A good starting point would be a mechanism or design option that rewards ambitious and dynamic baseline levels, including some measure of international average or best practice in environment. Such options are offered by the reformed CDM and sectoral crediting. JI and sectoral trading are less problematic because in theory they incorporate direct and explicit links to AAUs. However, this depends on the level of initial allocation of these units in light of environmental integrity.

Enhanced Public and Private Investment. Leveraging private investment depends on i) improving the investment conditions, in particular, improving the predictability of the processes and their time scales of operation and ii) making clear that there will be a rate of return for private sector capital. Sectoral crediting and sectoral trading depend on the host country's ability to implement intermediary, national systems. In general cap-and-trade types of emissions trading (e.g. sectoral trading) could leverage a greater scale of financial flows or private investments than other baseline-and-credit type options (reformed CDM, reformed JI, sectoral crediting).

Institutional strength. An effective mechanism must work well on its own, work together with other mechanisms and fit in with any future architecture devised. Timing is also a critical element in the evolution of existing mechanisms and the introduction of new ones, especially the end-dates for access to the mechanisms. There could be several paths built upon existing and new mechanisms. One possible path for consideration would be the transformation of sectoral crediting into sectoral trading through tightening the baselines, ultimately into economy-wide cap-and-trade. Another option would be to explore the possibility of converting the CDM into JI, inviting new Annex I countries and sectors. Clarification of these paths could offer investors more predictability on which to base their investment decisions.

II. Recommendations

Existing and new mechanisms

1. CDM and JI should enhance efficiency, transparency and governance.

CDM

- Confidence must be maintained in the CDM in order to encourage continued and future investment and increased participation from both Annex I and developing countries.
- Reform of the CDM governance should include a review of the procedural efficiency of CDM-related regulatory bodies, including the Executive Board, assurances for clear definition of roles and responsibilities of all bodies, the Board's transition to a permanent full-time body and the establishment of an appeal procedure for third parties.
- The governance reform should also attempt to simplify or improve the additionality assessment to reduce subjectivity and unpredictability.
- Parties should provide the CDM with a governance structure, management systems and guiding principles including due process, efficiency, predictability, consistency and transparency.
- Parties should streamline the registration and issuance process and simplify the procedures in order to increase efficiency.
- Parties should facilitate improvement in access to under-represented countries, sectors and technology types.

JI

- Host countries should introduce their own simplified procedures.
- Host countries should clarify Track I procedures that are currently either vague or unavailable.
- As reductions from JI projects are backed by the AAUs, the Track II requirements for additionality and baseline setting should in principle be simplified.
- Determination of Track II additionality and baseline criteria could be under the competence of the host country.

2. Offset crediting in the CDM should be limited.

- While ultimately the environmental integrity of a flexible mechanism is a function of the stringency of a country's commitment or an installation's cap as well as the nature of the mechanism itself, incentives embedded in the mechanism that would weaken the commitment or cap should be reduced or eliminated. In the CDM reform, offset crediting could, in time, be limited to credits from less advanced developing countries.

3. Sectoral benchmarking in the CDM and sector targets for JI should be considered as future options.

- Overlap between sectoral benchmarking in the CDM and sectoral crediting based on no-lose credits should be avoided. Clear definitions must be formulated for the two options in order to give unambiguous signals to investors.
- Countries hosting JI projects should be able to take on binding sector targets, thereby further stimulating the reduction of emissions from their key sectors and complementing the national cap.

4. In the future, JI should continue to allow host countries to choose whether to follow Track I or Track II and should integrate new Annex I countries and new sectors.

- The future JI should continue to give host countries the choice to rely on the JISC for the approval of projects (Track II) and accreditation of Independent Entities or to approve projects and implement national determination, verification and accreditation measures (Track I), provided the JI host country meets the full set of eligibility criteria under the Marrakesh Accords.
- JI should be made more attractive to countries or sectors that are potentially interested in joining the Annex I grouping and all efforts should be made to integrate these countries. As a matter of fact, an attractive JI could be used as a bargaining tool for countries to join Annex I.

5. The CDM could be transferred to JI.

- JI should be expanded so as to encompass the transformation of CDM project activities to a capped environment (backed by AAUs).
- Parties should consider how to link the verified future emissions reductions with AAUs once the CDM project activities are transferred to JI.
- Parties should explore how to manage the transition of CDM projects that will have been registered and already entered into their crediting period when the sector is capped.

An institutional framework and transition

6. An institutional framework for existing and new mechanisms should provide clarity about investors' access to market mechanisms and improve predictability about investment conditions.

- Confidence must be established in the market-based approach, in particular through demonstrating that there is long-term predictability associated with the flexible mechanisms and the carbon market.
- There should be an orderly transition between different types of flexible mechanisms. Governments should consult with market participants in designing how existing and new mechanisms can run alongside or in succession.

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- Reform of existing mechanisms should be practical with a view to making rules and procedures work better.
- Reformed mechanisms should be ready as soon as possible to allow a predictable transition through to the implementation of new mechanisms.
- While reformed mechanisms are up and running, support for capacity-building aimed at new mechanisms must be provided as it takes a long time for new mechanisms to become operational (e.g. setting benchmarks, agreeing on where to set the benchmarks and on how much flexibility is to be allowed in the benchmarks) and for institutions to be established.
- New mechanisms should be simple, functional and cost-effective for a participating company (e.g. the company's cost of participation should not outweigh expected benefits) and offer potential benefits to investors.

7. A long-term domestic regulatory framework ideally backed by an international agreement should be able to provide some clarity about stakeholders' access to market mechanisms and improve predictability about their investment conditions.

- Parties should provide rules on treatment of double counting especially during a transition period while more than one mechanism will likely operate simultaneously.
- Parties should make explicit the circumstances and timeframe under which a particular mechanism can be used.
- Parties should consider applying sunset clauses for changes to the different mechanisms.

8. Parties should consider at least two paths for evolving flexible mechanisms, sectoral approaches and transfer of the CDM to JI.

- In cooperation with stakeholders, Parties should accelerate and advance their discussions on sectoral crediting and sectoral trading with a view to reaching an understanding about the objectives and structure of each mechanism in Copenhagen. They should then move on to designing and operationalising each mechanism.
- Parties should explore paths for the evolution of CDM projects into the JI process for countries that have moved into Annex I in a new post-2012 agreement after Copenhagen, in parallel with possible sectoral approaches.

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